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20. (cont)

should reflect the effective corporation tax rate. The report does not address the additional adjustment presently applied to fees for Federal Contract Research Centers.

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MANAGEMENT FEES
FOR NONPROFIT
DOD CONTRACTORS

ADA 078 327

October 1979

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EXECUTIVE SUMMARY

Establishment of the profit or management fee paid to a Department of Defense contractor is governed by the Department's weighted guidelines profit policy. The weighted guidelines are used primarily with profit-seeking firms, whose earnings are subject to tax. Consequently a downward adjustment of management fee is necessary for nonprofit organizations receiving such fees.

Prior to Fiscal Year 1977 the downward adjustment was a fixed three percent of estimated cost. With adoption of the "new" weighted guidelines, adding facilities capital as a fee-bearing element, the "tax exempt adjustment" was reduced to one percent.

Subtraction of any fixed percentage from the "new" weighted guidelines profit calculation is inequitable. It does not properly correct the profit figure for the absence of a corporation tax. Nonprofit companies with large amounts of facilities capital have their management fees reduced too little; nonprofit companies with little or no facilities capital have their management fees reduced too much.

A more suitable course would be to apply a percentage adjustment; i.e., to multiply the "new" weighted guidelines profit result by a percentage factor. The percentage reduction should reflect the effective corporation tax rate. For the economy at large, that rate is about thirty percent.

Federal Contract Research Centers are a special case, not covered by this argument. Their management fees have required adjustment for reasons other than their tax-exempt status.

TABLE OF CONTENTS

	<u>Page</u>
EXECUTIVE SUMMARY	ii
 <u>CHAPTER</u>	
1. INTRODUCTION	1-1
Objectives and Scope of the Study	1-1
Fee Policy Background	1-3
Purpose of Fees	1-4
2. FINDINGS	
Scope of the Nonprofit Sector	2-1
Levels of Fees Negotiated	2-4
Levels of Facilities Capital Employed	2-6
3. POLICY ALTERNATIVES	3-1
4. RECOMMENDATIONS	4-1

1. INTRODUCTION

OBJECTIVES AND SCOPE OF THE STUDY

This study was undertaken to review recent levels of management fees (profit) paid by the Department of Defense to the nonprofit organizations with which it contracts for research and other services and to identify pertinent policy issues. The study was initiated because of a concern by the DoD that application of the new weighted guidelines profit policy (Defense Procurement Circular 76-3 and Cost Accounting Standards 414) to nonprofit organizations might be resulting in the payment of higher fees than were paid under the previous policy. The appropriateness of higher fees, if verified, was to be evaluated in terms of the purposes for which fee is paid nonprofit organizations.

The DoD awarded contracts amounting to nearly \$1 billion in fiscal year 1977 to organizations classified as nonprofit institutions. Forty percent of the total dollars were awarded to educational institutions, 50 percent to other research institutions of various types including university affiliates, and 10 percent to public utilities and local government organizations.

Awards made directly to educational institutions for research or tuition generally do not include a fee and are governed by a special set of cost principles. Research institutions, including university affiliates, however, typically receive a management fee. Research institutions fall into two categories:

1. Government-sponsored Federal Contract Research Centers (FCRCs) which have a special interdependent and continuing relationship with a sponsor and exist primarily to work for, and operate under direct monitorship of the principal sponsor.¹

¹The DoD sponsors six FCRCs: Institute for Defense Analyses, Center for Naval Analyses, Lincoln Laboratory, MITRE Corporation, Aerospace Corporation and the Project Air Force component of RAND Corporation.

2. Nonsponsored nonprofit organizations.

The study sponsor directed that the focus of this study is fee policy for nonsponsored non-profit organizations.

FEE POLICY BACKGROUND

In fiscal year 1977 the DoD revised the weighted guidelines applicable to most of its negotiated contracts to recognize facilities capital as a profit-bearing element. At the same time, an adjustment was made to offset the additional profit awarded. The adjustment was designed to reduce the total profit objective by an amount equivalent to the profit dollars produced by recognition of facilities capital for a contractor with an estimated average amount of facilities capital per dollar of sales. Its effect was to increase the total profit objective, measured as a percentage of costs, for capital intensive contractors and reduce the profit objective for other contractors, while leaving total DoD-wide profits unchanged.

The purpose of recognizing facilities capital as a profit-bearing element and deemphasizing cost elements was to encourage contractor investment or use of facilities. The express intention was to raise profit as a percentage of costs for contractors with greater than average amounts of facilities per dollar of sales or costs.

At the same time the revised weighted guidelines formula was promulgated in DPC 76-3, Cost Accounting Standard 414 was introduced. This standard provided for the allocability of the cost of facilities capital and its recovery as a cost by applying the government borrowing rate to the allocable book value of facilities capital. In effect, CAS 414 introduced an addition to profit for facilities capital when not otherwise offset, as discussed above, and tended to increase profit as a percentage of costs for capital intensive contractors. Facilities capital as an element of profit and as a cost (CAS 414) was intended to apply to contractor-owned facilities and to leased facilities where the constructive cost of ownership was applied.

The development of the new weighted guidelines and CAS 414 led to a change in the special adjustment for nonprofit institutions. Previously, fee objectives for nonsponsored nonprofit organizations were calculated as percentages of various cost elements using the old weighted guidelines method, then reduced by three percentage points. This procedure was introduced in December 1966 in DCP 50 which directed contracting officers to use the weighted guidelines method for nonsponsored nonprofit institutions with the aforementioned downward adjustment of three percentage points. A further downward adjustment was provided for sponsored nonprofit institutions (FCRCs).

Concurrent with the adoption of the new weighted guidelines in 1977, the downward adjustment was changed from three percentage points to one percentage point because the new weighted guidelines offset the profit calculated on cost by 30 percent. The DoD believed that nonsponsored nonprofit institutions had little facilities capital, and that the combined impact of the new weighted guidelines reduction for the cost component and the old three percentage point downward adjustment would lower fee objectives below reasonable levels.

PURPOSE OF FEES

Nonsponsored nonprofit institutions have two features that distinguish them from their for-profit counterparts: (1) they are exempt from Federal and other income taxes; and (2) they are prohibited from distributing net earnings for the benefit of private shareholders, individuals, officers, or trustees. If a nonsponsored nonprofit institution is dissolved, assets typically may be distributed only to a successor nonprofit institution or to another nonprofit institution legally qualified to receive gifts.

Nonsponsored nonprofit organizations appear to have no advantage over for-profit organizations relative to obtaining or executing government business, except that on occasion, the government has provided advances to nonsponsored nonprofit organizations to establish a working capital balance until they become self-sufficient. The organization

becomes self-sufficient typically through the accumulation of fees and then continues to finance its working capital requirements internally. It should be noted that it is not uncommon for government agencies either to provide letters of credit to for-profit contractors or to reimburse costs very quickly, so that contractor-provided operating capital is essentially nil on government work.

Consequently, there appears to be only one reason to "adjust" fee policy for nonsponsored nonprofit organizations relative to the policy used to establish profit objectives with for-profit organizations for comparable work: the tax-exempt status of the nonprofit organization.

Profit on government work is paid to for-profit contractors for the following purposes: (1) to cover the cost of capital employed (both operating and facilities capital raised through debt or equity); (2) to cover the risk that all costs (out-of-pocket and capital) are not recovered; and (3) to compensate for the entrepreneurial function of organizing and managing resources. For nonprofit institutions, only the first two purposes are relevant. Since nonprofit organizations cannot use equity financing, a third purpose for their fees is to finance in part additions to capital. For-profit organizations can gain access to equity capital markets and do not necessarily need funds generated from profits per se for equity financing, only the prospect of future profits on investments financed in the equity market.

Fees must also cover any out-of-pocket or operating costs not reimbursed because they are unallowable, or because of the type of contract used. Since research and development is usually contracted for on a cost-reimbursement basis, the contractor has no legal obligation to perform beyond the level of effort specified. However, some nonprofit organizations reported that they in fact had suffered overruns which were charged to fees.

Fees are also used to cover costs incurred when there are fluctuations in the level of contract effort or delays between contracts. Theoretically, the institution could avoid these costs through layoffs and rehiring, but it usually chooses to maintain its capability for the long run. If such fluctuations are frequent, it can also resort to the use of subcontractors, part-time employees, and/or consultants who assume the risk of variable contract activity.

In addition to these purposes for fees, several others have been mentioned. One is to fund a share of independent research that may benefit the government only indirectly. A second is to provide a fund to meet inflation-generated increases in required operating capital or to replace facilities capital at today's higher costs. However, since fees are mainly calculated as a percentage of costs, it follows that fee dollars increase in proportion to inflation as inflation raises costs. Finally, it is argued that fees are needed to fund diversification efforts when the contractor establishes a capability in related but different fields.

As discussed above, nonsponsored nonprofit institutions differ from for-profit contractors only with respect to their exemption from federal and other income taxes provided no part of their net earnings inures to the benefit of a private shareholder or individual.² With respect to other aspects of government contracting, nonsponsored nonprofit institutions are essentially similar to for-profit firms—sole source awards require identical justification and cost principles are identical. The distinguishing features are the tax-exempt status and the inability to access private capital markets for equity financing since dividends or other forms of income distribution are not allowed.

²Nonprofit exemption from taxes also requires that the organization refrain from certain political activities or attempts to influence legislation.

It therefore follows that nonsponsored nonprofit institutions should, with the possible exception of an adjustment for their tax-exempt status, be treated in a similar manner to for-profit institutions doing similar work. The argument against a special adjustment because of the tax-exempt status of nonprofit organizations has been made on the grounds that it was the intent of Congress to grant this privilege and that a full offsetting adjustment would negate this legislative intent. As a practical matter, this argument seems strained since it would place the nonprofit contractor at an advantage when competing against for-profit contractors. Funds that otherwise would be paid out as taxes could be used in part to subsidize project costs and allow the nonprofit organization to underbid the for-profit organizations. The intent of Congress was to afford nonprofit institutions tax-exempt status to conduct activities in the public interest, not to give nonprofit organizations a competitive advantage over the for-profit organization.

2. FINDINGS

SCOPE OF THE NONPROFIT SECTOR

The most accurate and complete information regarding the scope, level, and composition of the nonprofit sector comes from the Procurement Action Report File maintained by the DoD. This file contains a record of all procurement actions in excess of \$10,000 and is coded to indicate such information as: value of the action, contractor, type of action, contractor status, and type of contract. The Logistics Management Institute (LMI) obtained award data for every nonprofit contractor, separately and in total, for FY76 and FY77.

Table 2-1 groups the FY77 data by contractor type and dollar value of awards.

TABLE 2-1

AWARDS TO NONPROFIT INSTITUTIONS BY TYPE OF INSTITUTION--FY77

<u>Type</u>	<u>Dollar Value</u> <u>(\$000)</u>	<u>Percentage</u>
Research Institution:		
Awards Over \$1 Million	\$465,078	48.2%
Awards Between \$100,000 and \$999,000	9,953	1.0
Others	<u>3,701</u>	<u>0.4</u>
Subtotal Research Institutions	\$478,732	49.6%
Educational Institutions*	384,632	39.9
Utilities	52,250	5.4
Local Government Organizations	43,803	4.5
All Others	<u>4,848</u>	<u>0.5</u>
TOTAL	\$964,265	100.0%

* Awards to Johns Hopkins University (mainly the Applied Physics Laboratory) and Princeton University are included in the Research Institution total as are awards to university affiliates such as Purdue Research Foundation and Syracuse University Research Corporation.

Research and educational institutions dominate the nonprofit sector, with 50 percent and 40 percent of the dollar awards, respectively. Awards to educational institutions include reimbursement for tuition paid by the DoD on behalf of its employees as well as for the conduct of research activities. Of particular interest is the concentration of award dollars within the research institution category. Large institutions, defined as those receiving awards totaling \$1 million or more, account for over 97 percent of the dollars awarded to all research institutions. Within the "large" category, 27 institutions are represented, of which:

- four sponsored institutions (FCRCs) received \$191,141,000 or 41 percent of the large institution total
- the ten largest, excluding the FCRCs, received \$242,627,000 or 52 percent of the large institution total, and 89 percent of the large institution total excluding the FCRCs.

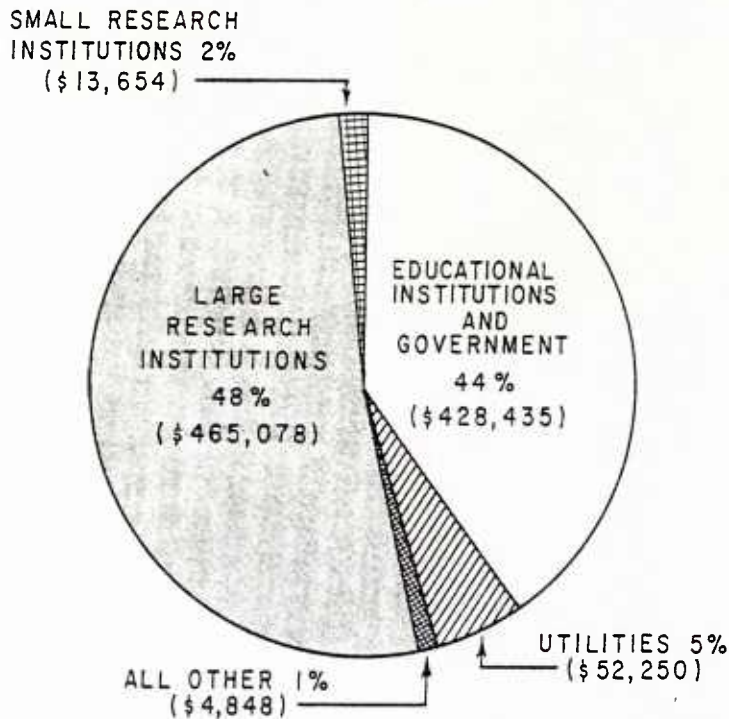
Consequently, our attention can be limited to a relatively small number of institutions which account for a large fraction of the awards in the nonprofit sector. Figure 2-1 displays the breakout of awards within the nonprofit sector.

After discussions with administrative officials of the Applied Physics Laboratory (APL), an affiliate of Johns Hopkins University, it was decided to exclude APL from historical consideration as a nonsponsored nonprofit organization, since APL had recently converted from FCRC status. When APL and the four DoD sponsored FCRCs are eliminated from the list, the nine largest remaining institutions account for nearly 75 percent of the remaining dollars awarded to nonsponsored nonprofit organization. The

nine nonsponsored nonprofit organizations where attention was focused are: Analytic Services Inc., Battelle Memorial Institute, Charles Stark Draper Laboratory, Environmental Research Institute of Michigan, IIT Research Institute, Riverside Research

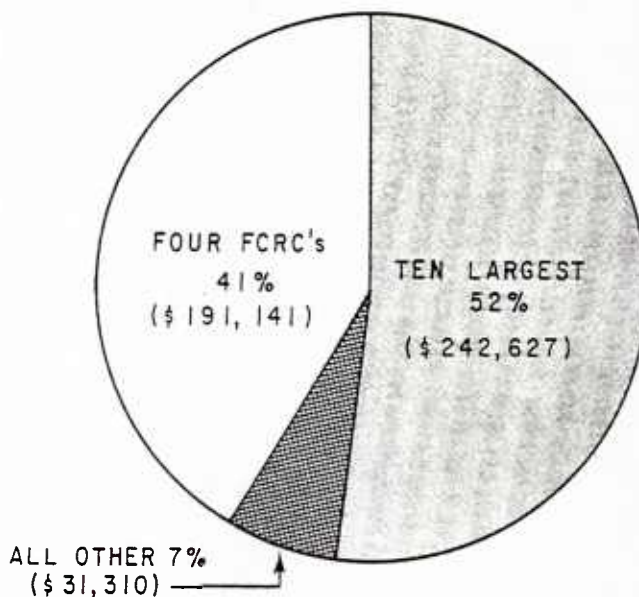
FIGURE 2-1

AWARDS TO NONPROFIT INSTITUTIONS: FY 77



TOTAL \$964,265

COMPOSITION OF AWARDS TO ALL NONPROFIT INSTITUTIONS
(\$000): FY 1977



TOTAL \$465,078

COMPOSITION OF AWARDS TO LARGE RESEARCH INSTITUTIONS
(\$000): FY 1977

Institute, Southwest Research Institute, SRI International, and Woods Hole Oceanographic Institute.³

LEVELS OF FEES NEGOTIATED

From these nine institutions LMI solicited financial data and comments relative to the level and use of fees with particular emphasis on the behavior of fee levels prior to and after the adoption of the new weighted guidelines and CAS 414. In two instances, the data requested were not supplied, which forced reliance on the DD Form 1499 data file. Unfortunately, the 1499 file contains profit plans only for large contract actions, does not include all purchasing activities, and does not report cost of money in the standard outputs. Consequently, fee comparisons were made on the basis of data obtained from seven institutions, not including Battelle and IIT.

Table 2-2 displays the results of fee comparisons for CPFF contracts in excess of \$100,000 negotiated between the seven institutions and various components of the DoD. The contracts in the sample represent approximately 36 percent of the FY77 total awards over \$10,000.

TABLE 2-2

COMPARISON OF FEES UNDER OLD AND NEW POLICIES

	<u>Old (FY76)</u>	<u>New* (FY77 or 78)</u>
Costs exclusive of fee and cost of money(CAS414)	\$37,251,190	\$61,242,650
Fee (including cost of money if taken)	\$ 1,772,690	\$ 3,801,630
Fee as a percentage of costs	4.8%	6.2%

*Data under New (FY77 or 78) are for FY77 with the exception of one contractor where application of CAS 414 began 1 January 1977 and covers a period after another was granted a deviation from application of constructive cost of ownership which materially reduced fees while increasing costs concomitantly.

³ Battelle Memorial Institute is technically a nonprofit corporation and appears in the DoD Procurement Report File as a nonprofit organization. However, under a recent IRS agreement, they are taxed as if they were a for-profit organization and consequently are not relevant to this discussion.

These fee data (which include cost of money) show increased fees calculated as a percentage of costs for four out of the seven institutions. One institution reported reduced fees, while another had an unchanged fee rate. The largest increases in fees were recorded by two institutions and amounted to nearly four percentage points. The distribution of fees, as defined to include CAS 414 cost of money, for the seven institutions is displayed in Table 2-3.

TABLE 2-3
DISTRIBUTION OF FEES

	Number of Contractors Old <u>(FY76)</u>	New <u>(FY77 or 78)</u>
Fee 4% or less	2	2
Fee 4% to 6%	2	1
Fee 6% to 8%	3	1
Fee 8% to 12%	0	3

Whereas fees as a percentage of costs did not exceed 8 percent under the old weighted guidelines, the application of the new weighted guidelines plus cost of money increased fees to the 8 to 12 percent range for capital intensive contractors.

Caution must be exercised in the interpretation of the data presented in Tables 2-2 and 2-3. We asked for an explanation of any substantial change in the level of fees negotiated, in particular, if the addition of contractor-owned facilities capital or changes from allowability of leased facilities to constructive cost of ownership (per DAR 15-205.34) had occurred. Such a change can have the effect of increasing fees as a percentage of costs while not necessarily increasing total price (cost plus fee) to the government. With the exception of one important contractor, no substantial changes were reported. That contractor was granted a deviation from DAR 15-205.34, and the data included in Table 2-2 under the "new" column are for contracts negotiated after the deviation was in effect to permit a more meaningful comparison.

LEVELS OF FACILITIES CAPITAL EMPLOYED

Fees negotiated under the new DoD profit policy reflect the level of facilities capital employed. If the level of facilities capital is higher than the average for all DoD contractors doing similar work, then it is reasonable and consistent with the intent of the new policy to have fees increase, measured as a percentage of cost, compared to prior fee levels.

From the information supplied to LMI, it is possible to derive the level of facilities capital employed per dollar of cost and to compare this level to the average for all CPFF contracts negotiated by the DoD. The profit review report prepared by the DoD indicates that for 253 CPFF contracts amounting to nearly \$500 million negotiated by the DoD in FY77, facilities capital employed amounted to approximately 13 percent of costs. Expressed differently, one dollar of facilities capital supported nearly \$8 of costs. This was the highest level of facilities capital relative to costs among the various contract types.

Of the nine nonsponsored nonprofit institutions surveyed, three did not, or did not plan to, include facilities capital cost of money as an allowable cost. These three institutions own minimal amounts of facilities capital or have leased facilities recognized as a cost rather than via constructive cost of ownership. For five of the remaining six institutions, facilities capital employed ranged from 12 to 55 percent of costs. A cost-weighted average of facilities capital relative to costs was 18 percent, or \$5.50 in cost per dollar of facilities capital. Thus, these institutions tend to employ, through outright ownership or because capital employed through rental or leases is treated as if it were owned, a higher level of facilities capital than the average CPFF contractor to the DoD.

3. POLICY ALTERNATIVES

In light of our findings, a number of policy alternatives are possible, ranging from maintenance of the current policy to adoption of a completely different approach specifically for nonsponsored nonprofit institutions. The possible alternatives are:

1. No change from the current (new) weighted guidelines method where facilities capital is recognized, cost of money is paid, and a downward adjustment of one percentage point on cost, is applied to nonsponsored nonprofit institutions.
2. Continued use of the new weighted guidelines method but retaining the old downward adjustment factor of three percentage points.
3. Continued use of the new weighted guidelines method but with a different adjustment factor expressed as a percentage of costs, which preserves an average historic fee level (old weighted guidelines) for nonsponsored nonprofit institutions.
4. Continued use of the new weighted guidelines method but with an adjustment factor expressed as a percentage of profit dollars reflecting the effective corporate income tax rate.

To quantify these alternatives, in terms of old and new weighted guidelines methods, Table 3-1 shows the calculation of profit objectives for the typical CPFF contract. Under the old method, the profit objective as a percentage of costs for the typical CPFF contract is 8.09 percent.

The nonsponsored nonprofit adjustment factor (three percentage points) reduces this to 5.09 percent which calibrates closely to the 4.8 percent rate observed for the institutions surveyed by LMI for FY76 when this method was in effect. Under the new weighted guidelines, profit on contractor effort is reduced by 30 percent (the 0.7

TABLE 3-1
WEIGHTED GUIDELINES PROFIT OBJECTIVE

	% COST BASE	% PROFIT	PROFIT AS % OF COST	"OLD" W-G	"NEW" W-G
Contractor Effort:					
Material Acquisition	24.0%	3.50%	0.840%		
Engineering Labor	25.0	12.50	3.125		
Engineering Overhead	25.0	7.70	1.925		
Manufacturing Labor	3.0	7.50	0.225		
Manufacturing Overhead	4.0	5.80	0.232		
Other Costs	7.0	4.90	0.343		
G&A	12.0	7.50	0.900		
Subtotal	100.0		7.590		
Adjustment Factor				N/A	X(.7)
Total Effort				7.59%	5.313 %
Risk (CPFF)		.50%		8.09%	5.813 %
Capital Employed	18.0%	7.50%			1.350 %
Nonprofit Adjustment				-3.00%	-1.0000%
CAS 414	18.0%	8.05%			1.449 %
Profit/Cost				5.09%	7.612 %

adjustment factor), while facilities capital employed bears profit in the weighted guidelines and via CAS 414. In Table 3-1, the profit on capital employed from these factors has been included under "new" weighted guidelines at profit rates of 7.5 percent and 8.05 percent, respectively. Combining all the elements that determine the weighted guidelines profit objective, plus the adjustment of .7 on contractor effort and the special downward adjustment of one percentage point for nonsponsored nonprofit organizations, gives an overall profit objective of 7.6 percent. This rate corresponds to the 6.2 percent reported from the survey results in Table 2-2 for the new weighted guidelines. The 1.4 percent variance on cost between the prototypical results in Table 3-1 and our survey findings probably arises from a slightly different mix of cost elements, different selection of fee rates within the weighted guidelines ranges, use of methods other than the weighted guidelines for some contractors, and a tendency by contracting officers to maintain fee objectives at historic levels.

Each alternative can be examined and analyzed with reference to Table 3-1.

1. Retain new Weighted Guidelines Method

With a special downward adjustment of one percentage point, continued application of the current policy would lead to fee objectives of from 4.8 percent on costs for a contractor without facilities capital, to 12.6 percent for a contractor with intensive amounts of facilities capital of 50 percent on costs. The contractor with average capital intensity for the nonprofit sector would derive an objective of about 7.5 percent on costs. Thus, the one percentage point downward adjustment preserves nominal fee objectives at the old weighted guidelines level for a contractor with no facilities capital and increases the fee objective above the historic level when facilities capital is employed.

2. Continue New Weighted Guidelines With Downward Adjustment of Three Percentage Points

This is a logical alternative since it is consistent with the methodology used to develop the new weighted guidelines method. The new weighted guidelines were intended

to maintain, but redistribute, the historic level of profits throughout the DoD. For the entire contracting community on average, the extent to which additional profit was paid on facilities capital was to be offset by the (.7) adjustment factor. Contractors with higher than average levels of facilities capital were to recover higher profits and conversely for those with lower than average capital intensity.

For the nonsponsored nonprofit sector, the same theory applies. If a nonprofit contractor has precisely the DoD-wide average level of facilities capital, then the fee level arrived at using the new weighted guidelines would be precisely the old level before the downward adjustment of three percentage points. A nonprofit contractor with higher than the average DoD-wide facilities capital would achieve higher fee rates (measured relative to cost) before the three percentage point adjustment as compared to old weighted guidelines.

Since the nonsponsored nonprofit sector has a somewhat higher level of facilities capital than the DoD average, application of the new weighted guidelines with the old three percentage point adjustment gives a fee objective of 5.6 percent on costs—about 0.5 percent higher than under the old weighted guidelines. A contractor with no facilities capital would receive a fee objective of slightly under 3 percent, a reduction of about 2 percentage points but nevertheless consistent with the intent of new weighted guidelines.

3. Continued New Weighted Guidelines with Adjustment to Maintain Historic Fee Levels

To maintain fee objectives at the historic level under the new weighted guidelines, the special downward adjustment would have to be increased from one percentage point to 3.5 percentage points, an additional 2.5 percentage points. This calculation is based on the average financial characteristics found for the nonprofit sector and comes from comparing the new and old results from the prototype examples in Table 3-1. A similar calculation using the survey results of Table 2-2 yields a required special downward adjustment of 2.4 percentage points, an additional 1.4 percentage points. Application of

either of these adjustment factors would produce results comparable to historic experience for contractors with average levels of facilities capital--those with below-average levels would tend to have fees below historic levels, while those with above-average levels would tend to have fees above historic levels.

4. Continued New Weighted Guidelines But Adjust Pre-Tax Fee Objective Directly

The special adjustment factor for nonprofit organizations was intended to develop fee objectives that produced after-tax results equivalent to those for profit-making contractors. This was a relatively straightforward calculation under the old weighted guidelines, since profit was calculated strictly as a percentage of the various cost elements. The introduction of facilities capital into the profit calculation makes the calculation of a tax-exempt adjustment factor as a percentage of costs difficult, since the amount of facilities capital per dollar of costs is highly variable across contractors. LMI's research showed this ratio to range from zero (when facilities are leased and the rental is fully allowed) to a high of over 50 percent.

Consequently, the new profit policy could employ an adjustment that is not expressed as a percentage of cost (since profit is no longer strictly calculated as a percentage of cost) but truly reflects the difference between before and after-tax profit. Such an adjustment represents the effective tax rate for corporations. The effective tax rate differs from the nominal rates contained in tax tables because income subject to tax differs from before-tax income reported in financial statements. Differences arise for reasons such as depreciation policy, accounting differences in the timing of receipt of income and the expensing of deductions, and the computation of certain income, deductions and credits for tax purposes only. To estimate the effective tax rate, which when applied to financial statement and government contract accounting gives after-tax profits, we analyzed the relationship found in the economy at large. We recognize that the effective tax rate will vary substantially from firm to firm, by industry and for a particular firm over time.

Table 3-2 below presents the effective tax rate found in the economy at large by sector from Federal Trade Commission data.⁴ These data suggest that effective tax rates are relatively constant within a sector over time. Further, effective tax rates appear to range between about 30 to 40 percent, with an average of about one-third. Consequently, the application of a reduction factor of about 30 percent to the profit level in the new weighted guidelines would be consistent with the intent of adjusting nonprofit fee objectives for tax-exempt status. The average nonprofit contractor would receive a fee of about 6 percent on costs using this procedure. A nonprofit contractor with no facilities capital employed would achieve a rate of about 4 percent.

TABLE 3-2
AVERAGE ANNUAL FEDERAL CORPORATE TAX RATE BY SECTOR:
1974-1978

	<u>All Mfg</u>	Mfg (\$5-\$10 Million <u>Assets)</u>	<u>Retail</u>	<u>Wholesale</u>	<u>Mining</u>
1974	32.4	45.0	*	*	*
1975	33.9	44.1	34.2	33.5	27.3
1976	34.2	44.4	30.6	30.1	28.8
1977	34.5	42.7	28.6	30.9	28.6
1978	34.2	40.9	29.1	32.6	30.6
Average	33.8	43.4	30.6	31.8	28.8

Overall Average of above sectors: 33.7

*Data not reported for all quarters of 1974

Source: Federal Trade Commission, Quarterly Financial Report for Manufacturing Mining and Trade Corporations, 1974-1979.

⁴Quarterly Financial Report, Federal Trade Commission, Washington, D. C., quarterly from 1974.

4. RECOMMENDATIONS

We have seen that application of the new weighted guidelines with the special downward adjustment of one percentage point on costs tends to produce higher fee levels for the average nonsponsored nonprofit than under the previous policy. We have argued that the rationale for the special adjustment is based exclusively on the nonprofit organizations' tax-exempt status and that such an adjustment is logical, desirable, and has a long historic precedent. The major policy issue in this context is how to introduce an adjustment that corrects for tax-exempt status and is equitable to nonprofit contractors irrespective of their financial characteristics.

Of the four alternatives discussed in the previous chapter, two do not meet these conditions. The first alternative, maintenance the status quo, has the deficiency that the downward adjustment of one percentage point cannot be supported. It leads to fee levels that exceed historic results, and it has no connection with the purpose of the adjustment—to account for tax-exempt status. The third alternative also has little merit. To "back into" an adjustment on cost based on maintaining historic fee levels for the nonprofit sector presumes that the historic level was correct. Yet nonsponsored nonprofits tend to employ more facilities capital than the average DoD contractor and consequently deserve more profit before adjustment for their tax-exempt status. In addition, such a technique singles out a particular sector of DoD contractors for special treatment.

The remaining two alternatives, reversion to the original downward adjustment of three percentage points and use of a percentage adjustment based on effective tax rates and applied to total profit dollar objective, can be defended logically. The three percentage point adjustment was in effect before the revision to the weighted guidelines method. The retention of this adjustment would maintain profit objectives for nonprofit

contractors who are facilitized at a level equal to the DoD overall average and raise profit objectives for those with higher than average facilities capital. A practical problem arises for those with little or no facilities capital as shown in Table 4-1 below.

TABLE 4-1

FEE OBJECTIVES WITH ALTERNATIVE ADJUSTMENT
FACTORS (PROFIT AS A PERCENTAGE OF COSTS)

<u>Adjustment Factor</u>	<u>Contractor Characteristics</u>		
	<u>No Facilities Capital</u>	<u>Average Facilities Capital</u>	<u>High Facilities Capital</u>
Reduction of 3 Percentage Points on Cost	2.8%	5.6%	10.6%
Reduction of 30 Percent on Total Profit Dollars	4.1%	6.0%	9.5%

The use of an absolute reduction of three percentage points on costs results in a very low profit objective for a contractor with no facilities capital. This is because an absolute percentage adjustment has a much greater effect when the pre-adjustment profit objective is low as compared to when it is high. However, the use of a percentage adjustment factor (30 percent in Table 4-1), because it is applied as a percentage to the total weighted guidelines profit dollar objective rather than as an absolute percentage rate, obviates this problem. A percentage adjustment factor also tends to compress the range of profit objectives more than does the three percentage point factor. Consequently, we support the use of a percentage adjustment factor. This technique has effects that are desirable from a practical point of view over the range of contractor characteristics that were found to exist. The suggested 30-percent rate has a basis in fact although we recognize that a somewhat higher or lower rate can be argued.

We believe such a technique to be equitable to all DoD contractors and consequently to be the preferred form for a nonprofit adjustment factor. The rate at which such an adjustment is to be applied should be supported by evidence available from FTC data or other reliable sources.